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In the Supreme Court of the United States

OCTOBER TERM, 1992

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether the purchaser of a newspaper business may treat the continuing patronage of existing customers as an intangible asset that is depreciable under Section 167 of the Internal Revenue Code, 26 U.S.C. 167.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-30a) is reported at 945 F.2d 555. The opinion of the district court (Pet. App. 31a-51a) is reported at 734 F. Supp. 176.

JURISDICTION

The judgment of the court of appeals was entered on September 12, 1991. A petition for rehearing with suggestion for rehearing en banc was denied on October 15, 1991 (Pet. App. 52a-53a). The petition for a writ of

certiorari was filed on January 13, 1992, and was granted on April 6, 1992. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATEMENT

1. In 1976, petitioner's predecessor, the Herald Company (Herald), purchased all the stock of Booth Newspapers, Inc. (Booth). Booth was the publisher of eight newspapers distributed in various Michigan communities. In 1977, Herald liquidated Booth and received all of its assets, including the eight newspaper operations. At the time of Booth's liquidation, those eight newspapers collectively had 460,000 regular subscribers.[1] Herald continued publication of the newspapers under their former banners after Booth was liquidated (Pet. App. 3a-4a, 34a-35a).

Following the liquidation of Booth, under the provisions of Sections 332 and 334(b)(2) of the Internal Revenue Code as then in effect, Herald was required to allocate its basis in the Booth stock (approximately $328 million) among the assets that it received from Booth's liquidation.[2] 26 U.S.C. 332, 334 (1976). In making this allocation, Herald was required to assign basis first to cash, cash equivalents and securities that it received from Booth, then to Booth's tangible and intangible assets (in proportion to their respective fair market values), with the remainder to be allocated to goodwill (Pet. App. 36a). See Treas. Reg. § 1.334-1(c)(4)(viii) (1978); *R.M. Smith, Inc.* v. *Commissioner*, 591 F.2d 248 (3d Cir.), cert. denied, 444 U.S. 828 (1979).

Herald allocated approximately $234 million of its basis in the Booth stock to cash, securities and tangible assets such as the land, buildings and equipment formerly owned by Booth (Pet. App. 36a). Herald then assigned approximately $68 million to an "intangible asset" that it described as "paid subscribers" (*id.* at 4a). This "intangible asset" represented simply the number of ordinary customers who, at the time of Booth's liquidation, subscribed on a daily, at-will basis to one of the Booth newspapers (*id.* at 4a, 12a, 38a-39a). See note 1, *supra*. Herald assigned a value of $68 million to this "intangible asset" under the following rationale: (i) due to factors such as death, relocation, and the mutable nature of consumer preferences, the average person who subscribed to Booth's newspapers on the date of Booth's liquidation would be expected to continue to purchase those newspapers for only a limited number of years, which Herald's experts estimated would vary from 14 to 23 years within the particular communities involved (Pet. App. 5a-6a, 39a); and (ii) during those average periods of continued consumer patronage, the newspapers would receive cumulative revenues from those pre-existing subscribers, net of

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[1] In the courts below, petitioner referred to these customers as "paid subscribers" (Pet. Br. 5; Pet. 4, 6, 7, 8, 9, 10, 15, 26). Any connotation that the subscribers had "paid" for their subscriptions in advance, however, is incorrect. To the contrary, as petitioner now acknowledges (Pet. Br. 4 n.5), these subscribers maintained ordinary daily subscriptions for home delivery that were "terminable at will" (*ibid.*) and subject to immediate cancellation without notice or obligation (Pet. App. 12a, 38a; J.A. 31-32). The only "contractual" (Pet. Br. 4 n.5, 9 n.11, 11-12, 39 n.44) claim that Herald possessed was the right to be paid for newspapers that were delivered: Herald had no contractual or other legal right to insist upon future performance, or demand future custom, from any of its so-called "paid subscribers" (Pet. App. 12a; see note 6, *infra*).

[2] Section 334(b)(2), 26 U.S.C. 334(b)(2) (1976), was repealed by Congress in 1982 and replaced by the somewhat different provisions of Section 338. Under the latter statute, an acquisition of the stock of a target corporation may be treated in certain circumstances as an acquisition of its assets. See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 11.46, at 11-62 (5th ed. 1987). If the assets of a target corporation are simply purchased directly, the taxpayer is also required to allocate the total purchase price among the acquired assets in accordance with their fair market values. See, *e.g.*, *F. & D. Rentals, Inc.* v. *Commissioner*, 365 F.2d 34 (7th Cir. 1966); *Copperhead Coal Co.* v. *Commissioner*, 272 F.2d 45 (6th Cir. 1959).

the costs of collection, equal to the present value sum of approximately $68 million (*id.* at 44a, 46a-47a).[3] Although these customers were free to discontinue their patronage of the newspapers at any time, Herald's valuation rested on the assumption that they would remain customers, and produce revenues for the newspapers, for an average of 14 to 23 years after ownership of the newspapers changed hands. After allocating approximately $68 million of its basis in the Booth stock to the "intangible asset" of its noncontractual relationships with its existing subscribers, Herald allocated the balance of the purchase price that remained (approximately $26 million) to "goodwill" (*id.* at 4a).

2. Section 167(a) of the Internal Revenue Code authorizes, as a deduction for depreciation, "a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business." 26 U.S.C. 167(a). On its income tax returns for periods following the liquidation of Booth, Herald sought to deduct a depreciation allowance with respect to the "intangible asset" it claimed existed in its relationships with its at-will customers. Herald claimed that this "asset" represented "property used in [its] trade or business" (26 U.S.C. 167(a)) that should be depreciated on a straight-line basis over the expected life of those customers' continuing patronage (Pet. App. 4a).

The Internal Revenue Service disallowed the claimed depreciation deductions. Since 1927, Treasury Regulations under Section 167 have consistently provided that "[n]o deduction for depreciation is allowable with respect

[3] In making this calculation, Herald did not reduce the subscription revenues by the costs that it would necessarily incur in producing and delivering the newspaper to its customers (Pet. App. 44a). The only costs deducted by Herald in determining the expected value of its existing relationship with its subscribers were the limited costs involved in collecting the subscription revenues (*ibid.*).

to goodwill." Treas. Reg. § 1.167(a)-3.[4] In the Service's view, the so-called intangible asset of "paid subscribers" (see note 1, *supra*) represents nothing other than the expected income from future patronage of present customers, which is the "goodwill" of the business that Herald purchased from Booth. The Service therefore concluded that Herald was not entitled to a deduction under Section 167.

Herald paid the additional income taxes resulting from disallowance of its claimed deduction for depreciation of its subscribers. When Herald was acquired by and merged into petitioner, petitioner filed administrative claims for refund of the additional taxes that Herald had paid. The Internal Revenue Service did not grant the requested refunds, and petitioner brought this suit in district court (Pet. App. 4a-5a, 33a-35a).

3. Following a bench trial, the district court ruled that the claimed depreciation deductions were allowable in full (Pet. App. 31a-51a). The court acknowledged that "[g]oodwill is conclusively presumed, per se, not to be depreciable" (*id.* at 49a) and that the so-called "paid subscribers" would qualify as a depreciable asset only if they were shown to have (1) a "limited useful life" whose duration could be estimated with reasonable accuracy and (2) "an ascertainable value separate and apart from goodwill" (*ibid.*). The court concluded, however, that petitioner had established that the existing subscriber

[4] Treas. Reg. § 1.167(a)-3 provides:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

relationships had a limited useful life to the business. In reaching this conclusion, the court relied on petitioner's statistical evidence that the subscribers who existed at the time of liquidation would, over a period of years, cease to be subscribers due to death, relocation, loss of interest in the newspapers, or other causes (*id.* at 40a-42a). Although it was not disputed that the total number of petitioner's subscribers in fact remained constant during the years in question (*id.* at 40a; J.A. 94), in the court's view it was "not relevant" that new customers replaced old ones, keeping the newspapers' circulation base intact (Pet. App. 40a).

The district court also concluded that the subscriber relationships had an ascertainable value to the newspaper company of approximately $68 million. That figure was calculated, under the methodology applied by petitioner, by capitalizing the stream of subscription income anticipated from the 460,000 existing subscribers over the average expected duration of their future patronage (Pet. App. 42a-48a).[5]

The district court further concluded that the $68 million attributed to this continuing patronage represented an asset separate and apart from goodwill (Pet. App. 32a-33a, 45a-48a). The court acknowledged that goodwill is the non-contractual expectation that "former customers will be retained—that there will be continued patronage" (*id.* at 32a, 45a). This is often described as "the expectancy that the old customers will resort to the old

[5] In calculating the net income from subscriptions for this purpose, the only costs that petitioner took into account were the relatively nominal ones of billing and collecting the subscription fees. The major costs of publishing and distributing the newspapers were omitted (Pet. App. 6a-7a & n.2, 29a, 44a). See note 3, *supra*.

The government did not attempt to value the stream of income that petitioner would derive from continuing sales of the Booth newspapers to existing subscribers. The government did, however, present evidence that it would cost less than $3 million to mount a circulation drive to develop a comparable number of subscribers (Pet. App. 6a, 29a-30a, 43a; J.A. 79-87).

place" (*ibid.*). In the court's view, however, a business enjoys goodwill only when it has "a galaxy" of anonymous customers "who may or may not return" and whose "future purchases cannot be predicted" (*id.* at 32a). The court stated that the subscribers involved in this case had value and longevity as customers that "can be measured with a fair degree of accuracy" and thus possessed "unique characteristics" separating them from "general goodwill" (*id.* at 45a). The court therefore concluded that petitioner satisfied both elements of the "two-pronged test" for depreciability and upheld petitioner's refund claims (*id.* at 49a).

4. The court of appeals reversed (Pet. App. 1a-30a). The court rejected petitioner's contention that any element of a business that is shown to have a limited useful life is, for that reason alone, distinct from goodwill (*id.* at 12a & n.6). The court noted that it has long been settled that goodwill, which represents the expectancy of continued patronage from existing customers, may not be depreciated (*id.* at 23a-25a). The court regarded it as implicit within the numerous decisions concerning goodwill (and explicit in some of them) that the non-contractual expectancy of future patronage from existing customers may not be written off as an amortizable asset even though such customers are subject to the normal consumer attrition that results from death, relocation, changing tastes, and similar commercial factors (*id.* at 25a-27a, 29a).[6] The court further noted that this con-

[6] The court of appeals observed that this case does not involve "contractually-based" rights (Pet. App. 11a) that would be amortizable under Section 167 (Pet. App. 11a-12a):

> [I]f the subscribers were contractually obligated to continue subscribing for some period of time, [petitioner] clearly would be permitted to depreciate the value of those contracts over that time period. In such an event, continued patronage would not be a mere "expectation," but a contractual right, and hence not goodwill. In the case at bar, however, all the subscribers are

clusion has long been embedded in Treasury Regulations that Congress has not disturbed (*id.* at 28a) and expressed reluctance "to announce a sudden redefinition of a concept so fundamental to tax accounting" (*ibid.*).

The court of appeals concluded that the value that petitioner imputed to its existing subscriber relationships "inherently includes much or all of the value of the expectancy that those customers will continue their patronage" and "is quite clearly comprised largely, if not exclusively, of amounts properly attributable to goodwill" (Pet. App. 30a). Finding that petitioner therefore failed to carry the burden of establishing "a value for its so-called paid subscribers that is separate and distinct from goodwill," the court disallowed petitioner's claimed depreciation deductions (*ibid.*).

The court of appeals acknowledged (Pet. App. 18a-23a) that *Dourey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987) (allowing amortization of newspaper "subscription lists"), and *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463 (1988), aff'd per curiam, 919 F.2d 1492 (11th Cir. 1990) (allowing amortization of a bank's "core deposits"), seemingly permit taxpayers to amortize "intangible assets" whose value depends on the expected future patronage of existing customers. The court noted, however, that those two decisions represent "no more than a minority strand amid the phalanx of cases" that have interpreted the statute and regulation to proscribe depreciation of such customer-based "intangible assets" (Pet. App. 23a).

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terminable-at-will. At the time of the acquisition of Booth, therefore, Herald merely expected continued patronage; it had no contractual right to demand it.

SUMMARY OF ARGUMENT

Section 167(a) of the Internal Revenue Code authorizes, as a deduction for depreciation, "a reasonable allowance for the exhaustion, wear and tear * * * [and] obsolescence" of property used in a trade or business or held for the production of income. This depreciation allowance is available only for wasting assets whose useful life in a business or other income-producing activity may be predicted with reasonable accuracy. The Treasury regulations under Section 167 therefore provide that "[n]o deduction for depreciation is allowable with respect to goodwill." Treas. Reg. § 1.167(a)-3. The prohibition against the depreciation of goodwill stems from the fact that goodwill inherently fluctuates in value and has an indeterminate useful life. The prohibition was first included in Treasury regulations in 1927. Carried forward essentially unchanged through repeated reenactments of the revenue laws, it has acquired the force of law. See *Cammarano* v. *United States*, 358 U.S. 498, 510 (1959); *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938).

The basic characteristic of goodwill has long been settled. Goodwill consists primarily in the advantage that the proprietor of a business enjoys from the likelihood that existing customers will continue their patronage and will ultimately be replaced by others. Goodwill may be attributable to the location of a business, its age, the quality of its products or services, or any other factor that blesses it with a favorable name and reputation, helping to attract "constant or habitual customers" (*Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893)). Goodwill is thus ordinarily described as the probability that "the old customers will resort to the old place." *Decker* v. *Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988).

The court of appeals correctly concluded that the $68 million that petitioner assigned as the value of its existing subscriber relationships represents a value that is not distinct from goodwill. These subscribers were non-

contractual, at-will purchasers of the Booth newspapers when Herald took over their publication. The $68 million that petitioner has assigned to these existing customers represents an estimate of the future income to be realized from their continuing patronage. The future income to be derived from the continuing patronage of existing customers is the very core of the concept of goodwill. The value of this future income is not subject to depreciation under the terms of the Treasury's long-standing regulations under Section 167. Treas. Reg. § 1.167(a)-3.

The court of appeals correctly rejected petitioner's argument that its customer relationships may be amortized as separate from goodwill because the subscribers will stop subscribing after a number of years due to death, relocation, loss of interest, or attrition for other reasons. The same is true, and could be estimated by statistical experts, for the customers of any business. Moreover, the very attributes of the Booth newspapers that attracted its subscribers in the first place would be expected to induce (and did induce) new customers to replace them, with the result that the circulation base of the newspapers has remained constant over the years. This ordinary turnover among an established clientele is, of course, a hallmark of the concept of goodwill and explains why goodwill has no determinate useful life even though individual customers are mortal. The value that petitioner attaches to its "old" subscribers is directly subsumed within the established concept of goodwill.

There is no merit to petitioner's claim that the decision of the court of appeals yields unreasonable tax consequences or departs from settled precedent. It is not unreasonable to deny petitioner an annual depreciation deduction for the value of its customer base when both in fact and as a matter of assumed economic behavior, that customer base has not depreciated. To the extent that the customer base of a business fluctuates from year to year, such annual fluctuations in the value of an enterprise are not recognized either as "loss" or as "gain" under the Internal Revenue Code. Moreover, as the court of appeals correctly observed, there is a "phalanx of cases" holding that the future income to be realized from the continued patronage of existing customers represents the very core of the concept of goodwill and is not depreciable under Section 167 of the Code.

ARGUMENT

THE CONTINUED PATRONAGE OF EXISTING SUBSCRIBERS IS NOT DEPRECIABLE UNDER SECTION 167 OF THE INTERNAL REVENUE CODE

A. The Goodwill Of A Business Is Not Subject To An Allowance For Depreciation Under Section 167 Of The Internal Revenue Code

Section 167 of the Internal Revenue Code authorizes as "a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of property used in a trade or business or held for investment. 26 U.S.C. 167(a). This statute permits the cost of depreciable property to be deducted in installments over the taxable periods that such property is expected to be useful in a business. When applicable, the allowance for depreciation promotes the objective of properly reflecting the taxpayer's income for each year, by matching business expenses with the periods in which those expenses aid in the production of income. *Indopco, Inc.* v. *Commissioner*, 112 S. Ct. 1039, 1042-1043 (1992); *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96 (1960). The tax-free recovery of capital through the depreciation allowance is also designed to generate funds for replacement of business property upon its retirement from service. *United States* v. *Ludey*, 274 U.S. 295, 300-301 (1927). See *Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. 272, 276 (1966); *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 101 (1943);

Northern Natural Gas Co. v. *United States*, 470 F.2d 1107, 1109 (8th Cir), cert. denied, 412 U.S. 939 (1973).

An asset may not be depreciated under Section 167 unless it will be consumed through exhaustion, wear and tear, or obsolescence over a period whose duration may be predicted with reasonable accuracy. Assets such as raw land (Treas. Reg. § 1.167(a)-(2)) or an antique violin (*Browning* v. *Commissioner*, 890 F.2d 1084 (9th Cir. 1989)), though useful in producing income, are not eligible for depreciation, for the value of such assets is not normally consumed within a fixed, determinate period. When "no specific * * * useful life can be ascertained" (*Indopco, Inc.* v. *Commissioner*, 112 S. Ct. at 1042) for an asset, its costs are not recoverable through depreciation. The costs of such an asset are instead recovered when the asset is sold, as a deduction from the proceeds of the sale in determining the gain or loss recognized from the transaction. *Ibid.* See also 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 23.2.4, at 23-22 (2d ed. 1989).[7]

Both tangible and intangible assets may be the subject of a depreciation allowance. Because intangible assets are immune from ordinary wear and tear and other forms of physical decay, however, they pose special problems in predicting the date (or the event) of their likely retirement from service. Under long-standing Treasury regulations, an intangible asset may be depreciated if it "is known from experience or other factors to be of use in the business or production of income for only a limited period, the length of which can be estimated with reasonable accuracy." Treas. Reg. § 1.167(a)-3. The specific examples identified in the regulation are copyrights and patents, whose legal life is prescribed by statute.[8] Since

[7] Alternatively, if the asset becomes worthless before it is sold, its owner may recover its basis tax-free by a "loss" deduction under Section 165 of the Code. See 26 U.S.C. 165(a) and (b).

[8] The basis of an acquired contract right may be amortized over the fixed term of the contract if that is an appropriate measure of the asset's economic life. When the contract is predictably subject to renewal, however, the asset has no determinate life and is therefore not subject to amortization. See *McCarthy* v. *United States*, 807 F.2d 1306 (6th Cir. 1986) (franchise agreement); *Miami Valley Broadcasting Corp.* v. *United States*, 499 F.2d 677 (Ct. Cl. 1974) (network affiliation contract); *Meredith Broadcasting Co.* v. *United States*, 405 F.2d 1214 (Ct. Cl. 1968) (FCC license); *Boe* v. *Commissioner*, 307 F.2d 339 (9th Cir. 1962) (medical service contracts); 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 23.2.6, at 23-28 (2d ed. 1989).

its first adoption, however, this regulation has stated unequivocally that "[n]o deduction for depreciation is allowable with respect to goodwill." *Ibid.* Rather than being depreciated, the value of goodwill is added to the capital structure of the business and treated as an offset against the proceeds received when the business is sold. See *Woodward* v. *Commissioner*, 397 U.S. 572, 574-575 (1970).

The premise of the regulatory prohibition against the depreciation of goodwill is that, like stock in a corporation, a work of art, or raw land, goodwill has no determinate useful life of specific duration. While the number of customers of a business (like the value of stock or of raw land) may fluctuate from year to year, those annual fluctuations are not determinate or predictable and are not recognized as either income or loss to the business. The prohibition against the depreciation of goodwill was first included in Treasury Regulations in 1927 (see T.D. 4055, VI-2 C.B. 63, amending Art. 163 of Treas. Regs. 69 (Revenue Act of 1926)). The regulation followed the then-recent decision in *Red Wing Malting Co.* v. *Willcuts*, 15 F.2d 626 (8th Cir. 1926), cert. denied, 273 U.S. 763 (1927), where the court observed that "there can be no wear or tear of good will, or exhaustion thereof" in the sense that would permit a deduction for depreciation (15 F.2d at 633).[9] Subsequent decisions re-

[9] The *Red Wing Malting Co.* case, like many early cases concerning the tax treatment of goodwill, involved the effect of Prohibition on the goodwill of breweries and distilleries. Those cases generated

peatedly have confirmed that goodwill "has no terminable life," but instead "continues in existence just so long as the business continues, and its value fluctuates in direct relationship with the annual variations in the profits of the business" (*Dodge Bros.* v. *United States*, 118 F.2d 95, 100 (4th Cir. 1941)).[10]

The Treasury's determination that goodwill, which fluctuates in value and has no fixed or determinate life, is therefore not subject to depreciation under Section 167, falls well within the scope of the Treasury's interpretive authority. See *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979) (Treasury regulations that " 'implement the congressional mandate in some reasonable manner,' must be upheld") (quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973) (quoting *United States* v. *Correll*, 389 U.S. 299, 307 (1967))).

a circuit conflict, resolved in *Clarke* v. *Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930), where this Court held that loss of the goodwill of a brewery as a result of Prohibition did not constitute "exhaustion" or "obsolescence" within the meaning of the statutory predecessor of Section 167. See also the companion case of *Renziehausen* v. *Lucas*, 280 U.S. 387 (1930). This Court's holding did not rest on the ground that goodwill is inherently nondepreciable, but rather on a "public policy" ground that Congress did not intend the depreciation statute to compensate for erosion of goodwill suffered by a business closed down as "noxious" under the Constitution (280 U.S. at 386). In *Gambrinus Brewery Co.* v. *Anderson*, 282 U.S. 638 (1931), however, the Court permitted a brewing company to deduct a reasonable allowance for depreciation where Prohibition caused obsolescence of its buildings. The Court explained that the cost of plant depreciation is one of the operating expenses necessary to a manufacturing business and must be taken into account in computing the net income generated by that business over the life of the plant. The Court distinguished *Haberle* and *Renziehausen* because they involved goodwill rather than tangible assets such as plant and equipment (*id.* at 642-643). See also *Burnet* v. *Niagara Falls Brewing Co.*, 282 U.S. 648, 651 (1931).

[10] Decisions with similar holdings are too numerous to cite. Many such decisions, spanning the period from 1927 to present date, are collected at Pet. Br. 24 n.24.

Deference is afforded to the Treasury's interpretations of the tax statutes because (440 U.S. at 477):

> "Congress has delegated to the * * * Commissioner * * *, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 U.S.C. § 7805(a)." *United States* v. *Correll*, 389 U.S. at 307. That delegation helps ensure that in "this area of limitless factual variations," *ibid.*, like cases will be treated alike. It also helps guarantee that the rules will be written by "masters of the subject," *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect.

The regulatory treatment of goodwill implements the mandate of Section 167 in a "reasonable" manner by confining the depreciation allowance to assets that, over a foreseeable period, predictably decline in value due to "exhaustion, wear and tear" (26 U.S.C. 167(a)). This central aspect of the regulation has been sustained repeatedly by the courts. Indeed, the nondepreciability of goodwill is "so well settled that the only question litigated in recent years regarding this area of the law is whether a particular asset is 'goodwill.' " *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240, 1247 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974).[11]

The regulatory proscription against the depreciation of goodwill has persisted without material change for 65 years,[12] through frequent reenactments of the tax

[11] See, *e.g.*, *Southern Bancorporation, Inc.* v. *Commissioner*, 847 F.2d 131, 137 (4th Cir. 1988); *Durovic* v. *Commissioner*, 542 F.2d 1328, 1334 (7th Cir. 1976); *Marsh & McLennan, Inc.* v. *Commissioner*, 420 F.2d 667, 669-670 (3d Cir. 1969).

[12] The essence of the restriction against the depreciation of goodwill has been perpetuated in successive versions of the regulation, including the one now in force. See Regulations 77, Art. 203 (Revenue Act of 1932); Regulations 86, Art. 23(*l*)-3 (Revenue Act of 1934); Regulations 94, Art. 23(*l*)-3 (Revenue Act of 1936); Treasury Regulations 103, § 19.23(*l*)-3 (1939 Code). The Treasury

laws.[13] "This case thus comes within the settled principle that 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to * * * have the effect of law.'" *United States* v. *Correll*, 389 U.S. 299, 305-306 (1967) (quoting *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938)).[14]

B. The Expectancy Of Future Patronage From Existing Customers Represents The Core Of The Concept Of Goodwill

The regulation does not itself define goodwill, nor is a definition provided by Section 167. The basic features of goodwill have long been established, however, and were well known before the regulation was first published in

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Regulations under Section 167 have frequently been before the Court. See, *e.g.*, *Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. at 283; *Hertz Corporation* v. *United States*, 364 U.S. 122, 123-124 (1960); *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 98 (1960).

[13] In recent years, bills to codify the regulation or, on the other hand, to relax its limitations by allowing amortization of some "customer-based" assets, have been proposed, but not enacted, as amendments to the Code. See H.R. Rep. No. 391, 100th Cong., 1st Sess. 1058 (1987); H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 937-938 (1987); H.R. Conf. Rep. No. 461, 102d Cong., 2d Sess. 546-547, 564 (1992). During the pendency of this litigation, bills have been introduced in Congress—and may soon be passed—to simplify tax accounting and avoid the barrage of tax disputes recently generated by taxpayers seeking to avoid the substantive distinction between non-depreciable goodwill and other intangible assets. Certain of these proposals would allow ratable amortization of purchased goodwill over relatively lengthy periods of time. See H.R. 11, 102d Cong., 2d Sess. § 4501 (1992) (proposing amortization of purchased goodwill, going-concern value and "customer-based intangibles" over a 14-year period). See also note 29, *infra*.

[14] See also *Cammarano* v. *United States*, 358 U.S. 498, 508-511 (1959); *United States* v. *Leslie Salt Co.*, 350 U.S. 383, 396-397 (1956); *Lykes* v. *United States*, 343 U.S. 118, 127 (1952).

1927. Both historically and currently, the essential characteristic of goodwill is the advantage that the proprietor of a business enjoys from the likelihood that existing customers will continue their patronage. *E.g.*, *Marsh & McLennan, Inc.* v. *Commissioner*, 420 F.2d 667, 669-670 (3d Cir. 1969); J. Story, *Partnerships* § 99 (7th ed. 1881).[15] Near the turn of this century, this Court stated that "goodwill" may be attributable to the location of a business, its age, the quality of its products or services, and any other factor that blesses it with a favorable name and reputation, helping to bring in "constant or habitual customers." *Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893). The Court later described "goodwill" as "that element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business." *Des Moines Gas Co.* v. *Des Moines*, 238 U.S. 153, 164-165 (1915). See also *Los Angeles Gas Corp.* v. *Railroad Comm'n*, 289 U.S. 287, 313 (1933). Those qualities are widely accepted as the core of the concept of goodwill. See *Black's Law Dictionary* 694 (6th ed. 1991). ("goodwill" is "[t]he favor which the management of a business wins from the public" and is "commonly defined as the expectation of continued public patronage"); 38 Am. Jur. *Good Will* § 1 (1968) ("[t]he narrowest definition" of goodwill is "the probability that the old customers will resort to the old place").

The same understanding of "goodwill" is reflected in the case law interpreting Section 167 and its implement-

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[15] Justice Story's treatise defined goodwill as the "advance or benefit which is acquired by an establishment * * * in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices." J. Story, *supra*, § 99. See also *Hitchman Coal & Coke Co.* v. *Mitchell*, 245 U.S. 229, 252 (1917); *Menendez* v. *Holt*, 128 U.S. 514, 522 (1888).

ing regulations.[16] The prohibition against depreciation of goodwill has produced much litigation, for

> [i]n general, businessmen are opposed to the nondepreciation rule. They would prefer to amortize goodwill fairly rapidly and thereby gain the advantage of substantial annual deductions.

Note, *An Inquiry into the Nature of Goodwill*, 53 Colum. L. Rev. 660, 726-727 (1953). The ordinary commercial impulse to obtain a rapid, tax-free recovery of invested funds has resulted in persistent efforts to obtain depreciation for "customer lists," "subscription lists," "insurance expirations" and other forms of "customer-based intangible assets." A long line of decisions has rejected these efforts (Pet App. 23a-25a (citing cases)) because "customer-based intangible assets" merely recognize the fact that a business has an existing, but not immortal or permanent, clientele. The value assigned to such intangibles thus represents only the goodwill of the business—the "expectancy of continued patronage" from existing customers or the prospect that "old" customers will return to the "old place." As the Third Circuit stated in *Marsh & McLennan, Inc.* v. *Commissioner*, 420 F.2d at 669-670, "[a]ny definition of goodwill includes the concept of the advantage that the proprietor of an existing business enjoys resulting from the probabilities that old customers will continue their patronage." See also *Commissioner* v. *Seaboard Finance Co.*, 367 F.2d 646, 649 (9th Cir. 1966) ("the essence of goodwill is the expectancy of continued patronage, for whatever reason"

[16] This same understanding of the concept of goodwill is also reflected in the legislative history of recent bills dealing with the subject (see note 13, *supra*). See H.R. Rep. No. 391, 100th Cong., 1st Sess. 1058 (1987) (under "[p]resent [l]aw," goodwill "has been defined as the expectancy of continued patronage, for whatever reason, or as the probability that old customers will resort to the old place"); H.R. Conf. Rep. No. 461, 102d Cong., 2d Sess. 546-547, 564 (1992) (goodwill includes "the value of a trade or business that is attributable to the expectancy of continued customer patronage").

(quoting *Boe* v. *Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962)); 5 B. Bittker & L. Lokken, *supra*, ¶ 132.4.5, at 132-73.

Invoking this substantial body of precedent, the court of appeals correctly concluded that goodwill denotes "the expectancy of continued patronage" and "the expectancy that old customers will resort to the old place" (Pet. App. 10a-11a). The court accurately described this definition of goodwill as one that the IRS has consistently applied and that the courts have "overwhelmingly" endorsed (*id.* at 28a).

C. Future Revenues From The Continued Patronage Of Existing Customers Of An Acquired Business Fall Within The Core Of The Concept Of Goodwill

The $68 million value that petitioner has assigned to the "paid subscribers" of the business it acquired, which it seeks to depreciate as a "wasting asset," falls precisely within this established concept of nondepreciable goodwill. This value represents the expected income from the future patronage of the existing customers of the newspaper businesses that petitioner acquired from Booth (Pet. App. 4a, 12a, 38a-39a). The value of such future patronage by existing customers of a business is the essence of the established definition of goodwill.

The customers whose patronage petitioner valued, and sought to depreciate, were those existing at the time that Herald stepped into the shoes of Booth and took over publication of the newspapers as a going concern (Pet. App. 3a-4a, 38a). Petitioner calculated the $68 million value in two basic steps. First, it used statistics to estimate that the existing, at-will subscribers would, on average, continue to subscribe to the Booth newspapers for 14 to 23 years until their patronage was lost due to death, illness, relocation, loss of interest or other commercial reasons (Pet. App. 5a-6a, 39a). Petitioner then calculated the present value of the future revenues (net of collection costs) that it anticipated receiving from those sub-

scribers during the estimated period of their continued patronage (Pet. App. 4a, 6a).[17] The $68 million therefore reflects simply petitioner's estimate of the value of the income it will earn from the continuing patronage of those existing subscribers.

In effect petitioner has appraised—and seeks to shelter from tax through an annual depreciation allowance—the future income that it anticipates receiving from the goodwill of the acquired business. The court of appeals correctly held that this income "inherently includes much or all of the value of the expectancy that those customers will continue their patronage," and therefore "is quite clearly comprised largely, if not exclusively, of amounts properly attributable to goodwill" (Pet. App. 30a). The value of this income forms the very core of the goodwill of the business acquired from Booth, and is thus ineligible for depreciation under the agency's longstanding regulation. Treas. Reg. § 1.167(a)-3. See 1 B. Bittker & L. Lokken, *supra*, ¶ 23.26, at 23-40:

> [L]ists of customers [and] subscription lists * * * are the documentary evidence of the 'customer structure' that is usually regarded as the very core of goodwill.

Except for the fact that the names of specific individuals could not be identified, there is no logical reason to differentiate the persons who regularly (or predictably) purchased newspapers at newsstands or coin boxes from those who had their newspapers delivered at home. Petitioner acknowledges that its "newsstand purchasers" represent one of its "basic customer relationships" (Pet.

[17] Petitioner's calculations were embodied in formal appraisals submitted into evidence (J.A. 52-73). While these appraisals purported to compute the "net" income to be derived from the newspaper subscribers, they failed to account for the actual costs of publishing the newspaper (Pet. App. 6a-7a n.2). One of the appraisers stated that he performed an "alternate" valuation which took publication costs into account and arrived at a value of $61.5 million (*ibid.*; J.A. 160-161). That valuation, as well as its methodology, was not reflected in a written report.

Br. 31). Petitioner also acknowledges that, by contrast with its home delivery customers, its "newsstand purchaser relationships were treated as part of [its] nondepreciable * * * goodwill" (*ibid.*). Petitioner states that it drew this distinction betwen home and newsstand customers because the latter "had no ascertainable lives or values" (*ibid.*).

Petitioner's analysis does not give due credit to the flexibility and inventiveness of expert testimony. It would be within the scope of expertise for a statistician to survey newsstand customers to determine the average regularity and duration of their patronage of a specific newspaper. It would then be within the expertise of an accountant to assign a value to the expected future patronage of these "existing" newsstand customers. A purchase made "once a week" or "twice a week" is as genuine—if less valuable to the business—as one made "once a day." Under petitioner's theory of Section 167, the goodwill of the newspaper thus could be wholly converted into a "wasting intangible asset" by statistical estimates predicting and valuing the expected (or average) custom of its different types of existing customers.

D. The Fact That Existing Customers Will At Some Time Die, Move Away, Or Stop Purchasing Petitioner's Newspapers For Any Variety Of Reasons Does Not Permit Petitioner To Depreciate The Goodwill Of Its Business

Petitioner ultimately concedes that the "tax laws treat goodwill as nonwasting and hence nondepreciable" (Pet. Br. 30). Petitioner contends, however, that the value that it has assigned to its existing subscriber relationships is conceptually distinguishable from goodwill. In petitioner's view, its relationships with existing subscribers had a determinate useful life, for they were destined to end as the subscribers moved away, died, lost interest in the newspapers, or stopped subscribing for any other reason. Because goodwill is normally described as having an indeterminate life, petitioner argues that the income anti-

cipated from the continued patronage of the existing subscribers must derive from something *other* than goodwill. According to petitioner, "[t]he proper inquiry under section 167 is *not* whether the asset is somehow connected to patronage, but rather, whether the asset is proven to be wasting" (Pet. Br. 28-29). This argument was correctly rejected by the court of appeals.

1. The fact that existing subscribers would cease to be subscribers within periods predictable by statistics does not differentiate the value of their continuing patronage from goodwill. As some customers predictably die or move away, others are predictably born (and grow to adulthood) or move in.[18] The very attributes of the newspapers that attracted the "old" customers in the first place help to induce new subscribers to replace them. Petitioner's statistician acknowledged that, notwithstanding the predictable and regular loss of some customers, other new customers appeared, and that the newspapers' overall circulation remained "constant" during the years examined (J.A. 94). He attributed this to a "birth and death process or renewal process" whereby "cancellations" were matched by "additions" (*ibid.*). Because the number of subscribers to the newspapers remained constant, the circulation base had the same value to the business (or to a prospective purchaser of the business) at the end of the taxable periods as at the beginning.[19] Such ordinary turnover, or "ebb and flow," among clientele of

[18] To state an obvious example, children of subscribers, who grow up with the newspaper in their home, may well become subscribers as adults and continue to subscribe long after their parents cease to be subscribers. New community members, who are neighbors of existing subscribers, may be influenced to become subscribers by the newspaper's continuing goodwill.

[19] The size of a newspaper's circulation often affects the rate it can charge for advertising space, which customarily provides the major source of revenue for newspapers (Pet. App. 38a). There is nothing in the record (or in logic) to suggest that the rates paid by advertisers for space in petitioner's newspapers varied as "old" subscribers left and "new" subscribers arrived, so long as the total number of subscribers remained "constant" (J.A. 94).

a business is a standard characteristic of goodwill, and a principal explanation of why a regular allowance for depreciation of "goodwill" is not permitted. See, *e.g.*, *Metropolitan Laundry Co.* v. *United States*, 100 F. Supp. 803, 805 (N.D. Cal. 1951) (gradual replacement of old patrons with new ones left the value of goodwill intact); *AmSouth Bancorporation & Subsidiaries* v. *United States*, 681 F. Supp. 698, 705 (N.D. Ala. 1988) (same).[20]

The loss of old customers and the acquisition of new ones represent offsetting changes in the value of a business that are subsumed directly within the traditional concept of goodwill. The source of petitioner's logical error is its designation of *a particular group* of subscribers as a "wasting asset" in an effort to treat them separately from the valuation of goodwill. Petitioner's effort to carve a depreciable component (existing "subscriber relations") out of a non-depreciable asset (goodwill) has routinely been rejected in analogous contexts. For example, taxpayers who own nondepreciable property (such as land or corporate stock) have sometimes created for themselves an interest in such property for a term of years. The taxpayer is not entitled to amortize this limited property interest because "[d]epreciability cannot be conferred merely by the voluntary, gratuitous division of * * * nondepreciable property into two segments, one of which becomes, as a result of the separation, wasting solely by * * * lapse of time." *United States* v. *Georgia Railroad & Banking Co.*, 348 F.2d 278, 288-289 (5th Cir. 1965), cert. denied, 382 U.S. 973 (1966). Accord, *Lomas Santa Fe, Inc.* v. *Commissioner*, 693 F.2d 71, 72 (9th Cir.

[20] Goodwill is not the only type of asset for which depreciation is not allowed. Whenever an asset is not subject to determinate and regular exhaustion, it is not depreciable under Section 167. See, *e.g.*, *Ithaca Industries, Inc.* v. *Commissioner*, 97 T.C. 253 (1991) (that some employees departed and others were hired did not make work force a depreciable asset), appeal pending, No. 92-1045 (4th Cir.); *Dietz* v. *Commissioner*, 7 B.T.A. 1048, 1050 (1927) (a water well is not depreciable because "like Jacob's well of old, it may last indefinitely").

1982), cert. denied, 460 U.S. 1083 (1983) (land not transformed into depreciable asset by reservation of term for years where taxpayer merely "fragment[ed] its bundle of property rights"); *Farmer* v. *Commissioner*, 1 B.T.A. 711, 711-713 (1925) (same). See generally 5 J. Mertens, *Law of Federal Income Taxation*, § 23A.129 (1992); 1 B. Bittker & L. Lokken, *supra*, ¶ 23.2.5, at 23-33 to 23-34; *id.* ¶ 23.2.6, at 23-43 to 23-44.

This general principle is applicable to this case. The continuing patronage of existing customers of an on-going business forms an integral part of its non-depreciable goodwill. The value of the income to be realized from the future patronage of those customers cannot be made depreciable by "split[ting] its bundle of property rights into two parts" (*United States* v. *Georgia Railroad & Banking Co.*, 348 F.2d at 288). The Code and regulation countenance no such "divide and conquer" approach to goodwill. The subscription income that petitioner expected to earn from the continuing patronage of the existing subscribers is not separable from the goodwill of the newspaper business.

2. Although petitioner's argument is not framed as a direct attack upon the Treasury regulation, acceptance of its position would pave the way for many taxpayers to circumvent the longstanding prohibition against depreciating goodwill. Contrary to petitioner's contention (Br. 31 n.33), its subscribers did not exhibit unique characteristics that set them apart from the customers of other businesses. Almost every commercial establishment or enterprise incurs a regular (and therefore a predictable) turnover among its patrons. These inevitable changes in the customer base of a successful business could be evaluated by the same statistical method used to evaluate the periodic turnover in petitioner's newspaper clientele. For example, an expert could no doubt be found to conclude that some specific percentage of a particular grocery store's customers are "regular customers" who shop at that store each week and who will, for some estimated average length of time, continue to do so until their

patronage is lost owing to death, relocation, or changing consumer preferences. The analysis employed by petitioner, which has attracted the support of amici in diverse lines of business,[21] thus could be used to convert the goodwill of almost any enterprise into a depreciable "intangible asset."

The facts of this case illustrate that acceptance of petitioner's contentions would go far toward "phas[ing] out the concept of goodwill" (*AmSouth Bancorporation & Subsidiaries* v. *United States*, 681 F. Supp. 698, 720 (N.D. Ala. 1988)). In an industry where the expected future patronage of existing customers (or "goodwill") is no doubt financially important, petitioner allocated to goodwill only $22 million of the $328 million that it paid for the stock of Booth (Pet. Br. 4, 31). The methodology employed by petitioner, if pressed to the hilt, would serve equally to eliminate even that $22 million vestige of goodwill. See pages 20-21, *supra*. The court of appeals correctly observed that petitioner's artificial economic analysis improperly converts "much or all of the value" (Pet. App. 30a) of nondepreciable goodwill into a depreciable construct that petitioner once named "paid subscribers" (see note 1, *supra*) and now seeks to describe as existing "subscriber relationships" (Pet. Br. 17).[22]

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[21] See, *e.g.*, Am. Br. of Colorado National Bankshares, Inc., at 7-8; Am. Br. of Charles Schwab Corp., at 2; Am. Br. of Worrell Enterprises, Inc., at 8-9. Taxpayers have long attempted to "whittle down the sphere so that the core of goodwill becomes non-existent." Gregorich, *Amortization Of Intangibles: A Reassessment Of The Tax Treatment Of Purchased Goodwill*, 28 Tax. Law. 251, 270-271 (1975).

[22] Petitioner's reliance on accounting conventions that deal with goodwill (Br. 29-30 & n.31) is similarly misconceived. Accounting principles, which are designed to yield a conservative statement of current income, do not override the explicit directive of the regulations that goodwill is not subject to depreciation under the Internal Revenue Code. See *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542-543 (1979) (given their different objectives, "any

3. Petitioner errs in asserting that goodwill is merely a "residual" concept under the Internal Revenue Code and has no "fixed content" or "substantive" meaning (Br. 13, 19, 25). The wealth of decisions describing the "substantive" meaning of the concept of goodwill is set out in full in the court of appeals' opinion (Pet. App. 23a-25a). See also pages 16-19, *supra*. Again and again, the case law has stated that the core of the concept of goodwill is the "expectancy of continued patronage" from "old customers * * * resort[ing] to the old place." See, *e.g.*, *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d at 1247 (citing cases). Although petitioner claims that this vast historical basis for the "substantive" meaning of "goodwill" under the Internal Revenue Code represents merely a "shibboleth" (Pet. Br. 26) that, for the better part of a century, courts have unthinkingly "misunderstood" (*ibid.*), petitioner's derogatory description of the case law cannot deprive the word of its accepted meaning. It was with this accepted meaning that the regulation was adopted in 1927, and it is with this accepted meaning that the regulation has since been applied.

Petitioner's claim that goodwill is a "residual" concept (Br. 19 & n.19) is, in any event, based on a misunderstanding of the so-called "residual" method of valuing and allocating basis to purchased intangibles. Under what is now Section 338 of the Code, the residual valuation method is applied when a business favorably positioned in its market is sold at arm's length to a taxpayer who continues to operate it as a going concern. On the assumption that cash and tangible assets are easiest to appraise, their value is deducted from the price paid, leaving the difference as the amount assigned to the intangibles. If the business includes patents, copyrights or similar intangibles that qualify for amortization, their value is also to be determined and subtracted, thereby isolating the "residual" amount attributable to goodwill and going concern

presumptive equivalency between tax and financial accounting would be unacceptable").

value.[23] This method, in somewhat circular fashion, associates with goodwill the "premium" that is paid over and above what other assets of the business would be worth if bought individually. See *R.M. Smith, Inc.* v. *Commissioner*, 69 T.C. 317, 320-323 (1977), aff'd, 591 F.2d 248 (3d Cir. 1979); *Concord Control, Inc.* v. *Commissioner*, 78 T.C. 742, 745-747 (1982); 5 B. Bittker & L. Lokken, *supra*, ¶ 132.4.5, at 132-74 to 132-75.

The residual valuation method was used by the parties in this case in order to narrow their dispute. It was stipulated that $234 million of the $328 million that Herald paid for the stock of Booth was allocable to tangible assets including land, buildings and equipment (Pet. App. 4a,

[23] The fact that "goodwill" has a substantive meaning that distinguishes it from other intangible assets is reflected in the regulations under Sections 338 and 1060 of the Internal Revenue Code, upon which petitioner mistakenly relies (Pet. Br. 19 n.19). These provisions, which were not in force during the years involved in this case, require the buyer and the seller to use the residual method to value assets conveyed in certain transactions. See 26 U.S.C. 338, 1060. A major purpose of this requirement is to promote consistent treatment by parties to the transaction. Previously, the Internal Revenue Service was exposed to a "whipsaw" if the buyer allocated less to goodwill than did the seller. S. Rep. No. 313, 99th Cong., 2d Sess. 251-255 (1986); see *Ullman* v. *Commissioner*, 264 F.2d 305, 308 (2d Cir. 1959).

The regulations under these Sections generally require the purchase price to be allocated first to "Class I assets" ("cash, demand deposits and similar accounts"), then to "Class II asets" (securities, stocks and bonds), then to "Class III assets" (all tangible and intangible assets "other than Class I, II and IV assets"), and then to "Class IV assets" ("goodwill and going concern value"). 26 C.F.R. 1.338(b)-2T(b)(1) and (2); 26 C.F.R. 1.1060-1T(d)(1) and (2). By excepting "Class IV assets" from the definition of "Class III assets," these regulations make clear that goodwill has a separate and distinct substantive meaning, for only those "intangible assets" *that are distinct from "goodwill"* may be valued and assigned a basis under the regulations. Petitioner's unsupported suggestion that the term "goodwill" lacks any substantive content under the "residual" allocation method is thus refuted by the very terms of the regulations on which it relies.

36a-37a). The parties further agreed that the balance of $94 million was allocable *among* goodwill, going concern value, and what petitioner called "paid subscribers" (*ibid.*). Thus, the stage was set for litigation of whether and to what extent the "paid subscribers" were to be assigned a value *distinct from* the going concern value and goodwill of the business. See note 23, *supra*. Use of the residual method helped to frame, but could not answer, that question. Petitioner's argument that goodwill is comprised of what remains after amortizable assets are identified and valued (Br. 19) simply begs the question presented. The residual approach to valuing the assets of a business under Section 338 does not deprive the word "goodwill" of its settled meaning in the regulations under Section 167. See notes 22, 23, *supra*.

4. There is no merit to petitioner's contention (Br. 14-17, 29-30) that denial of its claimed depreciation deduction will prevent proper matching of its revenues and expenses and cause distortion of its true net income. Analogizing its customer base to a wasting, depreciable asset such as a patent or a machine, petitioner suggests that its annual earnings will not be clearly reflected unless the predictable attrition of its old subscribers gives rise to depreciation deductions over the years that the attrition occurs.

These analogies are inapt for several reasons. First, the value to be derived from the future custom, or goodwill, of an enterprise does *not* predictably erode with time: some businesses prosper, others wane; some businesses do both. Under the Internal Revenue Code, the occasion for recognition of changes in the fluctuating value of an investment in an enterprise is at the time of its sale or liquidation, when "gain" or "loss" is recognized (26 U.S.C. 1001(a)). The Code does not require businesses to submit annual appraisals of their fair market value; nor does it seek to tax as income, or allow deductions as a loss for, the annual fluctuations in that value. Just as annual changes in the value of stock or raw land are not

recognized as income or loss under the Code, so too the annual changes in the fair market value of a business are not recognized. Since the value assigned to "goodwill" is associated with the economic "residual" or "excess" value of the enterprise,[24] the unpredictable annual changes in that value cannot support annual "loss" or depreciation deductions.[25]

This does not result in a distortion of petitioner's annual income by failing properly to match its annual expenses with annual income. The annual expenditures made by a business to maintain and promote its goodwill —such as, in the case of petitioner's business, advertising expenses, editorial salaries, and all other ordinary costs of marketing and producing a desirable product— are currently deductible. See 26 U.S.C. 162, 173.[26] The

[24] The economic value of goodwill is often described as the "excess" return derived from the expected continuing patronage of the business's clientele. See, *e.g.*, 5 B. Bittker & L. Lokken, *supra*, ¶ 132.4.5, at 132-74 to 132-75 (the value associated with goodwill is the premium paid over what other assets of the business would be worth if brought individually); Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 Harv. L. Rev. 859, 860 (1968); Note, *An Inquiry into the Nature of Goodwill*, *supra*, 53 Colum. L. Rev. at 712-713.

[25] If petitioner's theory were accepted, and the existing customers of the acquired business were deemed an "intangible asset" subject to depreciation under Section 167, parallel reasoning would suggest that, in the event of early departure of any of the customers, petitioner could deduct the "adjusted basis" allocated to that individual customer as a "loss" under Section 165. See 26 U.S.C. 165. For example, if a machine with a ten-year expected life breaks down after two years and cannot be repaired, the taxpayer could deduct its remaining basis in the machine as a "loss" under Section 165. Treating a departing customer of petitioner's newspaper business as a "loss" is, of course, as absurd as treating a newly arrived customer as a "gain"; but that reasoning is the premise of petitioner's submission.

[26] Section 162 allows a current deduction for "all the ordinary and necessary expenses" (26 U.S.C. 162(a)) of the business that are not subject to capitalization. See *Indopco, Inc.* v. *Commissioner*,

Code does not attempt the impracticable division of these annual, ordinary business expenses into "current" and "capital" components.[27] Since ordinary expenses incurred in maintaining and promoting goodwill are not capitalized, but are currently deducted, allowing petitioner an additional deduction for "depreciation" of goodwill would not yield a proper matching of income and expense: the "double deduction" of maintenance and depreciation expenses claimed by petitioner would occur even though the overall circulation of the newspapers and the economic goodwill of the business remained the same, as new subscribers replaced the old ones (J.A. 94)

112 S. Ct. at 1042-1045. Section 173 specifically permits a current deduction for all costs incurred "to establish, maintain, or increase the circulation of a newspaper, magazine or other periodical." 26 U.S.C. 173(a). This statute originated in the Revenue Act of 1950, ch. 994, § 204(a), 64 Stat. 906. It was enacted to clarify that expenditures to build up the circulation of a publication may be expensed annually, rather than capitalized and depreciated. See S. Rep. No. 2375, 81st Cong., 2d Sess. 63-64 (1950); *Florida Publishing Co.* v. *Commissioner*, 64 T.C. 269, 276-278 (1975), aff'd without opinion, 552 F.2d 367 (5th Cir. 1977). Section 173 excludes from its coverage the costs of acquiring circulation through a purchase of the business of another publisher (26 U.S.C. 173(a)) and thus does not permit petitioner to deduct its investment in the "old" subscriber relationships that it purchased from Booth.

[27] Certain isolated expenditures designed specifically to attract new customers to a business—such as subscription drives—have been held to be subject to capitalization because they aid in the production of income over several years. See, *e.g.*, *Meredith Pub. Co.* v. *Commissioner*, 64 F.2d 890, 891 (8th Cir.), cert. denied, 290 U.S. 646 (1933). Businesses have not, however, been required to allocate ordinary expenses—such as advertising, rent, the cost of maintaining clean or attractive premises or of hiring effective managers and other personnel—into partially-capital and partially-current components, even though goodwill may often or largely be derived from such expenses. See Note, *An Inquiry into the Nature of Goodwill*, *supra*, 53 Colum. L. Rev. at 690. In the case of publishing enterprises, even isolated subscription drive expenses are currently deductible under Section 173. See 26 U.S.C. 173; note 26, *supra*.

and the value of the customers' patronage was thus unaltered (see note 19, *supra*).

If petitioner's depreciation claim were allowed, the costs it associates with purchasing and maintaing its subscriber relationships would be written off and fully recovered—as if they had lost all their value—even though the circulation of its newspapers remained entirely intact. Petitioner understandably seeks to have the best of both worlds: it seeks a current expense deduction for the costs of maintaining and promoting its circulation *and* amortization of its circulation even though it is not declining. Petitioner's claim thus conflicts with the express terms of the regulation and Section 167, which confine depreciation to the predictable loss associated with assets that inevitably wear out over a determinate period. See *Lindheimer* v. *Illinois Bell Tel. Co.*, 292 U.S. 151, 167 (1934) (depreciation represents "the loss, *not restored by current maintenance*, which is due to all the factors causing the ultimate retirement of the property" (emphasis added)).

Although petitioner has not proposed it, there is an alternative, logically consistent method to account for these expenses. Petitioner could be required to *capitalize*, rather than deduct currently, all of the current expenses it incurs to maintain and promote its circulation (as well as the expenses it incurs to purchase circulation from others) and then be allowed to amortize those expenditures over some appropriately lengthy period of estimated benefit. This, however, would require an impracticable division of current expenses (such as editorial and production costs) into partially-current and partially-capital outlays. Congress has specifically elected to avoid that confusing, litigious inquiry. See 26 U.S.C. 173; notes 26, 27, *supra*. Since there is no practicable method to identify and allocate such customer-related costs annually (and there is also no practicable method to appraise the fair market value of businesses annually to determine the actual fluctuations in the economic value of their

goodwill),[28] the practicable solution adopted by the Service under the Code is to permit a current deduction for the ordinary expenses that generally maintain and develop customer patronage (under Section 162) and *not* to permit annual depreciation of goodwill. It is this practicable method that the Code and the regulations under Section 167 adopt for achieving an annual income statement that most "clearly reflect[s] income" (26 U.S.C. 446(b)).[29]

E. The Decision In This Case Comports With Settled Precedent

The court of appeals correctly stated that its decision in this case is in accord with a "phalanx of cases" (Pet. App. 23a) that have rejected similar efforts to depreciate the value that a business associates with the future patronage of its existing customers—the probability that "the old customers will resort to the old place" (*Decker* v. *Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988). Over the long history of the regulation, courts have frequently disallowed amortization deductions to purchasers

[28] See Note, *An Inquiry into the Nature of Goodwill*, *supra*, 53 Colum. L. Rev. at 689 ("even if it were desirable to show present values [of goodwill], to do so would be highly impracticable").

[29] If, as current legislative proposals contemplate (see note 13, *supra*), a business were permitted to amortize purchased goodwill as a wasting, capital asset, the logical corollary would be to require capitalization of the current expenses incurred to develop and maintain that capital asset. See *Indopco, Inc.* v. *Commissioner*, 112 S. Ct. at 1045 (the distinction between ordinary and capital expenses "envisions an inquiry into the duration and extent of the benefits realized by the taxpayer"). Otherwise, the taxpayer would be allowed to recover tax-free all of its investment in an asset that cannot be assumed (and is not shown) to have diminished in value merely by the passage of time. Capitalization of such expenses, however, has not ordinarily been required. See note 27, *supra*. In any event, current legislative proposals have no bearing on the proper disposition of cases to be decided under the existing regulations proscribing depreciation of goodwill.

of customer-based "intangible assets" whose value was tied directly to goodwill, such as customer relationships,[30] distributorships,[31] insurance expirations,[32] and the circulation structure of newspapers and magazines.[33] See 1 B.

[30] See, *e.g.*, *Skilken* v. *Commissioner*, 420 F.2d 266 (6th Cir. 1969); *Golden State Towel & Linen Service, Ltd.* v. *United States*, 373 F.2d 938, 944 (Ct. Cl. 1967); *Commissioner* v. *Seaboard Finance Co.*, 367 F.2d 646, 649-650 (9th Cir. 1966); *Nelson Weaver Realty Co.* v. *Commissioner*, 307 F.2d 897, 901 (5th Cir. 1962); *Boe* v. *Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962); *United States Industrial Alcohol Co.* v. *Helvering*, 137 F.2d 511 (2d Cir. 1943); *AmSouth Bancorporation & Subsidiaries* v. *United States*, 681 F. Supp. 698 (N.D. Ala. 1988); *Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223, 235 (1975); *Credit Bureau of Erie, Inc.* v. *Commissioner*, 54 T.C. 726, 731 (1970).

[31] See, *e.g.*, *Falstaff Beer, Inc.* v. *Commissioner*, 322 F.2d 744, 747-748 (5th Cir. 1963); *J.C. Cornillie Co.* v. *United States*, 298 F. Supp. 887 (D. Mich. 1968).

[32] See, *e.g.*, *Decker* v. *Commissioner*, 864 F.2d 51 (7th Cir. 1988); *Ralph W. Fullerton Co.* v. *United States*, 550 F.2d 548, 550 (9th Cir. 1977); *Marsh & McLennan, Inc.* v. *Commissioner*, 420 F.2d 667, 669-670 (3d Cir. 1969); *Commissioner* v. *Killian*, 314 F.2d 852, 855 (5th Cir. 1963); *Squires* v. *United States*, 289 F. Supp. 597, 600-601 (C.D. Cal. 1968); *Thoms* v. *Commissioner*, 50 T.C. 247, 256 (1968). See also Rev. Rul. 65-175, 1965-2 C.B. 41.

[33] See *National Weeklies, Inc.* v. *Commissioner*, 137 F.2d 39, 42 (8th Cir. 1943) ("[t]he Board [of Tax Appeals] has repeatedly held that a newspaper subscription list is an intangible asset, not ordinarily limited as to time in its use, and so not subject to allowable depreciation for tax purposes"); *Meredith Pub. Co.* v. *Commissioner*, 64 F.2d 890 (8th Cir.), cert. denied, 290 U.S. 646 (1933); *Imperial News Co.* v. *United States*, 576 F. Supp. 865, 867-868 (E.D.N.Y. 1983), aff'd without opinion, 742 F.2d 1434 (2d Cir. 1984); *Toledo Newspaper Co.* v. *Commissioner*, 2 T.C. 794, 809 (1943); *Moon Journal Publishing Co.* v. *Commissioner*, 13 B.T.A. 1379, 1382 (1928); *Danville Press, Inc.* v. *Commissioner*, 1 B.T.A. 1171, 1172 (1925); cf. *Finoli* v. *Commissioner*, 86 T.C. 697, 739 (1986) (CATV subscribers). See also *Strong Pub. Co.* v. *Commissioner*, 56 F.2d 550, 551 (7th Cir. 1932); *Herald-Despatch Co.* v. *Commissioner*, 4 B.T.A. 1096, 1105 (1926); *Gardner Printing Co.* v. *Commissioner*, 4 B.T.A. 37, 39-40 (1926).

Bittker & L. Lokken, *Federal Income Taxation of Income, Estates and Gifts* ¶ 23.2.6, at 23-40 (2d ed. 1989) ("[L]ists of customers [and] subscription lists * * * are the documentary evidence of the 'customer structure' that is usually regarded as the very core of goodwill").

Among the more recent of such cases is *Decker* v. *Commissioner*, 864 F.2d 51 (7th Cir. 1988). In *Decker*, one insurance agency purchased the business and assets of another, including records known as "insurance expirations" that contained information for servicing and soliciting renewals of policies issued to the seller's clients. The buyer took over the seller's business as a going concern, succeeded to its assets, personnel and business location, and intended to use the insurance expirations to maintain the continued patronage of the seller's clients. The court of appeals rejected the buyer's claim to amortize these insurance expirations, for they had no ascertainable value separate from the goodwill of the acquired business. The court observed that goodwill is "the expectancy that 'the old customers will resort to the old place.'" *Id.* at 54 (quoting *Winn-Dixie Montgomery, Inc.* v. *United States*, 444 F.2d 677, 681 (5th Cir. 1971)). In the court's view, it was "irrelevant" whether the taxpayer established a limited useful life for the insurance records based on attrition among the existing customers, for the records were so closely related to the transfer of goodwill that they lacked the status of a discrete amortizable asset. 864 F.2d at 53, 55.

Similarly, in *Boe* v. *Commissioner*, 307 F.2d 339 (9th Cir. 1962), the taxpayers purchased (and thereafter carried on) a medical practice, which included numerous at-will contracts to provide health care services to patients for a fee. The court held that depreciation was not allowed for the value of the contracts in force at the time of the purchase, because that value "depend[ed] entirely upon the expectation that they will not be terminated—that is, the expectancy of continued patronage," which

the court noted was "the essence of good will" (*id.* at 343). The court concluded that the expiration of the existing contracts did not diminish the business in a manner recoverable through depreciation, especially since the business regularly entered into new contracts as the old ones expired, so that the total number outstanding remained the same or even increased during the relevant period. *Id.* at 341, 343.

1. Petitioner nonetheless makes the strained assertion that the decision in this case is "aberrational" (Pet. Br. 33) and disrupts "settled expectations" concerning the tax treatment of such customer-based intangibles (*id.* at 32). In petitioner's view, the "landmark" decision of the Fifth Circuit in *Houston Chronicle Publishing* and subsequent case law support a different result (Pet. Br. 34). That assertion was correctly rejected by the court of appeals.

Houston Chronicle Publishing is distinguishable from this case in all of its important respects. The *Houston Chronicle* was a daily newspaper that purchased the land, equipment, subscription lists and other assets of the *Houston Press*. Unlike the present case, however, the *Chronicle* did not receive the right to use the name or masthead of the *Press* and did not attempt to continue its publication. Instead, after the sale, publication of the *Press* was terminated. 481 F.2d at 1243-1244.

Because there was no intention of continuing publication of the *Press*, the *Chronicle* "did not consider the subscription lists [of the *Press*] to be self-regenerating assets and considered them valuable only to the extent they furnished names and addresses of prospective subscribers." 481 F.2d at 1244. The *Chronicle* estimated that (i) the average cost of obtaining a *new* subscriber was $2 and (ii) the subscription lists could be used in a marketing campaign to obtain 35,600 *new* subscribers for the *Chronicle*. The *Chronicle* therefore estimated that the fair market value of the customer lists it obtained from the *Press* was $71,200, which it sought to amortize over a five-year period. *Id.* at 1243-1244.

Affirming the jury verdict for the *Chronicle*, the Fifth Circuit concluded that the value of subscription lists is amortizable when the "lists are bartered and sold as discrete vendible assets" apart from a going concern. 481 F.2d at 1253. Acknowledging that goodwill represents the "expectancy of continued patronage" (*id.* at 1247), the court correctly held that an intangible asset may be depreciated if it (*id.* at 1250):

> (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy.

This holding does no more than reiterate the clear and specific language of the Treasury Regulation. See 481 F.2d at 1250 (citing Treas. Reg. § 1.167(a)-3).[34]

The description of *Houston Chronicle* as a "landmark" decision stems from petitioner's effort to ignore the *first* factor stressed by that court and emphasize the *second*. The mere fact that a customer-based "intangible asset" can be articulated in a fashion that suggests it has a "limited useful life" is not sufficient for amortization under the regulation *or* under *Houston Chronicle* and the vast "phalanx" of related decisions (Pet. App. 23a). The taxpayer must also show that its customer based "intangible asset" has a value "separate and distinct from goodwill" (481 F.2d at 1250) and thus separate and distinct from the "expectancy of continued patronage" (*id.* at 1247).

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[34] After *Houston Chronicle* was decided, the Service announced that depreciation deductions for customer lists, insurance expirations, and similar "customer-based" intangibles, would be allowed "in an unusual case," where a taxpayer makes a factual showing along the lines of *Houston Chronicle*. Rev. Rul. 74-456, 1974-2 C.B. 65, 66. The revenue ruling cautioned, however, that such assets "[g]enerally" are nondepreciable because they are in the nature of goodwill, representing "the customer structure of a business, their value lasting until an indeterminate time in the future." *Ibid.* This admonition was in effect when Herald liquidated Booth in 1977.

The court of appeals correctly explained why that *first* condition was met in *Houston Chronicle* but is not met in the present case (Pet. App. 17a):

> The *Houston Chronicle* did not purchase an ongoing business or even a tradename as did [petitioner], but rather the idle assets of the defunct *Houston Press*. Hence, there was no "expectancy that old customers would resort to the old place" because "the old place" no longer existed. The value of the customer list to the *Houston Chronicle* therefore lay solely in its potential use as a marketing tool to solicit *new* customers to a *new* business.

Unlike the *Chronicle*, petitioner stepped into the shoes of Booth, kept up the publication of the Booth newspapers under the same banners, and seeks to amortize the estimated value ($68 million) of the future income it expects to derive from the continuing patronage of the Booth subscribers. Petitioner's expert did not appraise the utility of a "subscription list" in canvassing for new subscribers; instead, he appraised the future income to be obtained from the ongoing patronage of existing "subscriber relationship[s]" (J.A. 130-131). Petitioner concedes that there is a "stark difference" in these two concepts (Pet. Br. 47 & n.50). *Houston Chronicle* did not involve the transfer of ongoing customer relationships and provides no support for petitioner's depreciation claim in this case.

Houston Chronicle follows the mold of decisions that allow amortization of acquired customer lists when the buyer did not *also* succeed to the seller's business as a going concern.[35] A taxpayer who acquires a customer

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[35] See, *e.g.*, *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 454, 456-457 (Ct. Cl. 1976) (taxpayer purchased assets of insurance agency, including insurance expirations, but did not use seller's name, location, office procedures or personnel; amortization allowed for value of insurance expirations measured by what it would have cost buyer to solicit and place on its books a comparable amount of new business); *Robins & Weill, Inc.* v. *United States*, 382 F. Supp. 1207 (M.D.N.C. 1974) (taxpayer brought insur-

list without the trade name or work force of the seller cannot rely on the list to effect a transfer of *continuing* patronage or goodwill of the business. In that situation, the customer list provides only a marketing tool, not an assurance or "expectancy" of gaining the custom of the seller's clients.

As the court noted in *General Television, Inc.* v. *United States*, 449 F. Supp. 609 (D. Minn. 1977), aff'd per curiam, 598 F.2d 1148 (8th Cir. 1979), "in the instances in which customer or subscriber lists have been determined to have an ascertainable value separate and apart from goodwill, the lists alone carried with them no expectancy of continued patronage" (449 F. Supp. at 611-612). Accord, *Decker* v. *Commissioner*, 864 F.2d at 55; *Panichi* v. *United States*, 834 F.2d 300, 301-302 (2d Cir. 1987). See note 35, *supra*. The court of appeals correctly emphasized that distinction in this case (Pet. App. 29a-30a):

> Even in those cases where customer lists have been deemed depreciable, the value assigned to the lists

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ance expirations from each of two different agencies, in one case accompanied by a transfer of the seller's name, business location, and staff, but not in the other; the court held that these expirations represented nondepreciable goodwill in the former case, not the latter); *Panichi* v. *United States*, 834 F.2d 300, 302 (2d Cir. 1987) (taxpayer acquired customer list from company in trash collection business, but seller retained trade name and sold most of its route stops to third parties; amortization of customer list was permitted, although court indicated that result would have been different if buyer had purchased "entire business[] as going concern[]" rather than obtaining the list "as an asset separate from a going concern"); *Manhattan Co.* v. *Commissioner*, 50 T.C. 78, 87-88, 93 (1968) (buyer of customer lists did not receive right to use seller's trade name and the lists were "not acquired as a part of a going business"; amortization was allowed to the extent that the lists were valued as "information" that helped the buyer to contact new customers). In *Decker* v. *Commissioner*, 864 F.2d 51, 54-55 (7th Cir. 1988), the court held that a customer list is not depreciable when buyer "step[ped] into the shoes" of seller's insurance agency. The court distinguished *Miller* on its facts because the purpose of the transaction in that case "was not to buy an ongoing business." *Ibid.*

> has been limited to the *cost* of generating a like list of potential subscribers or customers. As a general matter, the courts have not permitted customer lists to be valued as the stream of *income* to be generated by the listed customers over their remaining years of patronage. * * * In this case, the Service offered expert testimony that the 460,000 subscribers to the Booth newspapers could be valued on a cost basis at roughly $3 million, whereas [petitioner's] experts valued the same subscribers on an income basis at over $67 million! More importantly, this difference in the two valuation approaches implicates the central legal dilemma at issue. The fact is that, when employed in the context of the sale of an ongoing concern, the income approach to valuing a list of customers inherently includes much or all of the value of the expectancy that those customers will continue their patronage—i.e., the goodwill of the acquired concern.

See also *Dodge Bros.* v. *United States*, 118 F.2d 95, 101 (4th Cir. 1941) ("A valuation based upon the capitalization of the average of a company's earnings over a number of years smacks peculiarly of a method used in evaluating good will.").

2. a. Although the decisions addressing the depreciation of intangibles are often factually dissimilar, we agree with petitioner (Pet. Br. 35-36) that *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987), bears a close resemblance to this case in several respects. In *Donrey*, the taxpayer bought a newspaper business for $1.3 million. Like Herald, the taxpayer in *Donrey* "stepped into the shoes" of the former owner by continuing to publish the paper under the same name. The taxpayer sought to depreciate a written subscription list (showing the number, names and addresses of subscribers) that it obtained during the purchase of the newspaper as an intangible asset having a limited useful life and a value apart from goodwill. It calculated that figure as "the present value of the difference in advertising reve-

nues generated by the subscription list as compared to the revenues of an equivalent paper without a subscription list." *Id.* at 536. "This value was thus characterized as being separate and apart from goodwill." *Ibid.* In affirming the jury verdict in favor of the taxpayer, a divided panel of the court of appeals concluded that the question whether the subscription list was an asset with a limited life that was separate from goodwill was one of fact for the jury. *Id.* at 536-537.

The issue addressed in *Donrey* is factually distinct from the issue raised in the present case. In *Donrey*, the taxpayer made an effort to identify its written "subscription list" as an asset separate and apart from its continuing non-contractual relationship with its subscribers. Instead of simply calculating the future subscription revenue to be derived directly from those subscribers (as petitioner did in the present case), the taxpayer in *Donrey* computed the additional future advertising revenues that it hoped to obtain by showing its subscription list to potential advertisers. See 809 F.2d at 536.

We disagree with the conclusion of the majority in *Donrey* that this indirect benefit of continuing patronage is separable from the value of goodwill. The taxpayer in *Donrey* succeeded directly to the seller's goodwill in the process of taking over the latter's business as a going concern. The value of the goodwill thus acquired is the benefit derived from the expected future patronage of the customer base of the business. That benefit encompasses both the direct purchases that such customers will make in the future and the indirect advantages of their continuing patronage—such as economies of scale and higher advertising rates—that allow the business to earn a profit on its assets at rates above ordinary returns on invested capital. See note 24, *supra*. Stated more simply, the benefit to the ongoing business is derived not *from the list of customers* but from the continuing patronage that the list symbolizes. As Judge Bright correctly observed in dissent

in *Donrey*, in words equally applicable to this case (809 F.2d at 538-539):

> Of course, the existing subscription list will change from time to time. But, that change does not make the list a depreciable asset.

b. We also agree with petitioner (Pet. Br. 36-38) that *Citizens & Southern Corp.* v. *Commissioner*, 919 F.2d 1492 (11th Cir. 1990), aff'g per curiam 91 T.C. 463 (1988), and *Colorado National Bankshares, Inc.* v. *Commissioner*, 60 T.C.M. (CCH) 771 (1990), appeal pending, No. 91-9019 (10th Cir.), are not consistent with the ordinary rule that "intangible assets" based solely upon the continuing patronage of existing customers are not depreciable. The question in *Citizens & Southern Corp.* was whether the buyer of a bank may amortize the value of the bank's "core deposits," a term defined by the taxpayer to refer to the funds that the bank's customers had on deposit at relatively low rates of interest at the time ownership of the bank changed hands. Such deposits provided a significant source of the bank's income because the bank used them to make loans at higher rates of interest. The Commissioner argued that this "core deposit" intangible represented simply the value associated by the taxpayer with the expectation that existing customers would—due to inertia, convenience or commercial preference—continue their patronage by leaving funds on deposit with the bank for a number of years. The Tax Court, however, permitted the buyer to amortize the value of its "core deposits" as an asset that would "waste" as the existing depositors eventually withdrew those funds from the bank. 91 T.C. at 505-512.[36]

In the present case, the Third Circuit correctly declined to follow *Citizens & Southern Corp.* The court observed that the rationale of *AmSouth Bancorporation & Subsidiaries* v. *United States*, 681 F. Supp. 698 (N.D. Ala.

[36] The Tax Court reached a similar conclusion in *Colorado National Bankshares, Inc.* v. *Commissioner, supra.*

1988), was a more "persuasive and well-articulated" (Pet. App. 27a) analysis of the depreciability of customer-related intangibles such as "core deposits" (681 F. Supp. at 720):

> For accounting purposes, a bank may be able to "identify" a customer deposit base even though it may not be separate and distinct from goodwill. To the extent that deposits remain after some contractually stipulated period, they result from, "continued patronage." The mere fact that the deposits themselves are identifiable, does not make their "*value*" separate and distinct from goodwill. Other facets of bank activities such as safe deposit "expectations," loan "expectations," etc. could perhaps be similarly "identified" so as to phase out the concept of goodwill.

The value of the "core deposits" in *Citizens & Southern* was directly related to the noncontractual proclivity of the "old customers to return to the old place," which is the very essence of goodwill. Nor did the bank's statistical showing concerning the likely duration of their continued patronage suffice to differentiate that value from goodwill. Although individual depositors might come and go, the overall level of deposits was not shown predictably to diminish or waste in the manner required to permit a deduction for depreciation. See 91 T.C. at 521 (Williams, J., dissenting).[37]

Petitioner's assertion that the judgment of the court of appeals in this case disrupts "settled expectations" and

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[37] The Tax Court has declined to extend the approach of the "core deposits" cases to other contexts. In *Ithaca Industries, Inc.* v. *Commissioner*, 97 T.C. 253 (1991), appeal pending, No. 92-1045 (4th Cir.), the court held that a taxpayer who bought a company as a going concern was not entitled to amortize the value it ascribed to the company's existing work force. The court reasoned that the company's personnel did not become a wasting asset merely because some of the existing employees were bound to leave and new ones would be hired in their place. The court explained that "[t]he turnover rate of employees represents merely the ebb and flow of a continuing work force" (97 T.C. at 267).

"marks a significant departure from two decades of rulings" (Br. 32) is demonstrably incorrect. Under established authority of recent as well as older vintage, the settled definition of goodwill is the value associated with the expectancy of continued customer patronage. See, *e.g.*, *Decker* v. *Commissioner*, 864 F.2d at 54; pages 16-19, *supra*. The court of appeals correctly concluded in this case that the few decisions that fail to follow this definition, and that permit amortization of "intangible assets" whose value is premised on expected future patronage from existing noncontractual customers, represent "no more than a minority strand amid the phalanx of cases that have considered the definition and application of the term 'goodwill' in the context of [Treas. Reg.] § 1.167 (a)-3, and which support the Service's position" (Pet. App. 23a).

3. The court of appeals was also correct in rejecting petitioner's claim that amortization should be allowed in this case on the theory that petitioner's "subscriber relationships" are contractual in nature (Pet. App. 11a-12a). Contractual relationships, such as contracts not to compete, or personal service contracts, are subject to amortization because the contract itself specifies that the relationship will last only for a fixed term, thereby establishing its determinate life and wasting character. See 1 B. Bittker & L. Lokken, *supra*, ¶ 23.2.6, at 23-36 to 23-38; but see note 8, *supra*. Goodwill, on the other hand, denotes an expectancy that a customer relationship will continue "without contractual compulsion." *Commissioner* v. *Seaboard Finance Co.*, 367 F.2d 646, 649 (9th Cir. 1966). Accord, *General Television, Inc.* v. *United States*, 449 F. Supp. at 613. The court of appeals cogently explained that distinction as follows (Pet. App. 11a-12a):

> In the case at bar, however, all the subscribers are *terminable-at-will*. At the time of the acquisition of Booth, therefore, Herald merely expected continued patronage; it had no contractual right to demand it.

Contrary to petitioner's arguments (Br. 39-42), its future relationships with its subscribers are not contractually based or defined. The subscribers were merely daily, at-will customers who arranged to have petitioner's newspapers delivered to their homes by mail or carrier, rather than buying the paper at a newsstand or coin box (Pet. App. 38a). Petitioner had no contractual or other right to insist upon future performance or demand any future custom from any of these subscribers (see note 1, *supra*). Petitioner had only an "expectancy" that they would continue to subscribe, and thereby continue to generate subscription revenues for the enterprise, after Herald took over Booth's publishing operations as a going concern. The value that petitioner assigns to the future revenues it anticipates receiving from the continued patronage of existing customers is nondepreciable goodwill.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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